

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

VERNON KEITH GRAVES and THEODORA GRAVES,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

HAROLD J. GRAVES and BEULAH F. GRAVES,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

FILED

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No. 22,004

VERNON KEITH GRAVES and THEODORA GRAVES,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

No. 22,004-A

HAROLD J. GRAVES and BEULAH F. GRAVES,

Petitioners

v.

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ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 53-
66) 1/ are officially reported at 48 T.C. 7.

1/ "I-R." and "II-R." references are to Volumes I and II of the
record on review.

JURISDICTION

The petitions for review in these consolidated cases (I-R. 87-89-90-92), involve federal income taxes for the taxable calendar years 1958, 1960, 1961, 1962, and 1963. 2/ On March 26, 1965 and March 1965, the Commissioner of Internal Revenue mailed to the respective taxpayers notices of deficiency (I-R. 4-10, 16-25) asserting deficiencies in income taxes in the following amounts for the years in issue (I-R. 1-10, 13-25.)

<u>Docket Number</u>	<u>Petitioner</u>	<u>Year</u>	<u>Deficiency</u>
22,004	Vernon Keith Graves and Theodora Graves	1960	\$ 1,063.01
		1961	2,233.11
		1962	706.03
		1963	2,263.65
22,004-A	Harold J. Graves and Beulah F. Graves	1958	9,189.17
		1961	418.79
		1962	1,274.41
		1963	4,434.60

Within ninety days thereafter, on June 25, 1965, the taxpayers filed petitions with the Tax Court for redetermination of those deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-10, 13-25.) The decisions of the Tax Court were entered on June 8, 1967. (I-R. 76, 86.) The cases are brought to this Court by petitions for review filed on June 15, 1967 (I-R. 87-89, 90-92), within the three-month period prescribed in Section 7483 of the Internal Revenue Code. Jurisdiction is conferred on this Court by Section 7482 of the Code.

2/ The year 1960 is involved in No. 22,004 solely because of the elimination of a net operating loss carryback from 1963 due to the Commissioner's adjustments in the taxpayers' income for 1963. The year 1958 is involved in No. 22,004-A solely because of the elimination of net operating loss carryback from 1961 due to the Commissioner's adjustments in the taxpayers' income for 1961. (I-R. 54.)

QUESTIONS PRESENTED

1. Whether the Tax Court was correct in concluding, as a factual matter, that the useful lives of the taxpayers' industrial structures and components therein had respective useful lives of thirty eight and twenty eight years for the purpose of computing depreciation deduction thereon.

2. Whether the Tax Court was correct in its factual conclusion that the Commissioner was not precluded, from adjusting the useful lives of the subject assets by reason of subsection 3.05 of Part II of Revenue Procedure 62-21.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations involved are set out in the Appendix, infra.

STATEMENT

The relevant facts as found by the Tax Court may be briefly stated as follows:

Taxpayers Vernon Keith Graves and his wife, Theodora, are residents of Oregon. They filed joint income tax returns for the years 1960, 1961, 1962 and 1963 with the District Director of Internal Revenue for the District of Oregon. Taxpayers Harold J. Graves and his wife, Beulah, are residents of Oregon. They filed joint income tax returns for 1958, 1961, 1962 and 1963 with the District Director of Internal Revenue for the District of Oregon. (I-R. 55.)

Sawyers, Inc., is a manufacturer of stereoscopic slides, viewers and other photographic equipment, and it is also engaged in

research along these lines. Sawyers, Inc., maintains its home office and manufacturing complex in Progress, Oregon. Harold Graves was associated with Sawyers, Inc., for 34 years. He was president of the corporation and a member of its board of directors from about 1931 to 1957. (I-R. 55.)

In 1951, Sawyers, Inc., hereafter referred to as Sawyers, purchased land at 3500 N. Kostner Avenue, Chicago, Illinois, containing 23,043 square feet for \$17,722.38 ^{3/} and in 1952, constructed a single story structure for \$158,579.61. A second floor was added during 1954 at a cost of \$95,870.13. The first and second floors contained a total of 28,500 square feet. On November 28, 1958, Sawyers purchased the adjoining land and building at 3512 N. Kostner Avenue from Bell & Howell Corporation for a total purchase price of \$366,375, which was allocated \$342,524 to the building and \$23,851 to the land. The two-story building at 3512 N. Kostner Avenue was constructed in 1952 and contained a total of 41,020 square feet. Sawyers used the Chicago property as a distribution center, a sales office, and for research and development. (I-R. 55-56.)

Sawyers used the following useful lives for the purpose of computing depreciation of the buildings at 3500 and 3512 N. Kostner Avenue:

<u>Location</u>	<u>Useful Life</u>	<u>Depreciation Commenced</u>
3500 N. Kostner Avenue	40 years	10/1/52
3500 N. Kostner Avenue (2nd Floor Addition)	38 years	10/1/54
3512 N. Kostner Avenue	34 years	1/1/59

^{3/} The Tax Court found an unexplained discrepancy in the stipulation in the cost of the land and the book value of the Chicago property as of August 31, 1959. (I-R. 55.)

The corporation did not separate the components from the buildings for the purpose of computing depreciation. (I-R. 56.)

As of August 31, 1959, the book value of the Chicago property owned by Sawyers was as follows (I-R. 56):

Buildings

3500 N. Kostner Avenue (Orig. bldg.)	\$ 131,160.48
3500 N. Kostner Avenue (2nd Floor Addition)	83,465.97
3512 N. Kostner Avenue	<u>335,807.84</u>
	\$ 550,434.29

Land

3500 N. Kostner Avenue	\$17,772.38
3512 N. Kostner Avenue	<u>23,851.00</u>
	<u>41,623.38</u>
	\$ 592,057.67

On September 1, 1959, the following stockholders of Sawyers acquired the Chicago property from the corporation in return for stock in Sawyers, having a value of \$592,057.67:

<u>Stockholder</u>	<u>Undivided Percentage Ownership</u>
Harold J. Graves	36.90 percent
Beulah F. Graves	36.90 "
Vernon Keith Graves	10.81 "
Theodora J. Graves	.62 "
Robert Graves	10.81 "
Juanita M. Graves	.62 "
Rex Graves	<u>3.34</u> "
	<u>100.00</u> "

The above stockholders are hereinafter called the owners. (I-R. 56-57.)

After acquiring the Chicago property the owners leased the property back to Sawyers under a written lease for a 5-year term starting on September 1, 1959 and ending August 31, 1964 at a monthly rental of \$3,000. The lease contained a renewal option which Sawyers

exercised thereby extending the lease term for the 5-year period starting September 1, 1964 and ending August 31, 1969 at a monthly rental of \$3,750. Under an instrument dated December 28, 1964, the owners, for a stated consideration of \$15,000, granted to Sawyers an option to lease the Chicago property for another term of 5 years starting on September 1, 1969 and ending August 31, 1974 at an annual rental of \$45,000. (I-R. 57.)

Under the terms of the lease the lessee was obligated to pay for insurance coverage of various types and to maintain the leased premises, including heating and air conditioning systems, interior wiring and plumbing, and drain pipes to sewers or septic tanks in good order and repair during the entire term of the lease at the lessee's own cost. (I-R. 57.)

For the purpose of computing the annual depreciation deduction on the Chicago property, the owners assigned a 25-year life to the two buildings and a 5-year life to heating, electrical and plumbing components of each building. A total depreciation deduction of \$39,387.51 was computed on their tax returns by the owners of the Chicago property for each of the years 1960, 1961, 1962 and 1963 as follows (I-R. 57-58):

Asset	Cost	Useful Life	Depreciation
Bldg. - 3500 N. Kostner	\$ 91,651.82	25 years	\$ 3,666.00
Heating, etc., components	39,508.66	5 "	7,902.00
2nd floor addition	65,566.89	25 "	2,622.69
Heating, etc., components	17.899.08	5 "	3,579.00
Bldg. - 3512 K. Kostner	284,648.34	25 "	11,385.93
Heating, etc., components	<u>51,159.50</u>	5 "	<u>10,231.89</u>
	\$550,434.29		\$39,387.51

A depreciation schedule showing the above computation was attached to the income tax returns filed by taxpayers (as well as the other owners of the Chicago property) for the years 1960 through 1963. In each of those years, the total depreciation of \$39,387.51 was subtracted from the \$36,000 received as annual rental of the Chicago property under the lease to show a net loss of \$3,387.51 each year in connection with the Chicago property. This net rental loss of \$3,387.51 from the Chicago property was then allocated to the various owners in each of the years 1960 through 1963 on the basis of their undivided interests in the Chicago property. (I-R. 58.)

The Commissioner determined in his statutory notices of deficiency that the two buildings at 3500 and 3512 N. Kostner Avenue in Chicago each had a useful life of 45 years and that the components in each of the buildings had a useful life of 25 years. Accordingly, he disallowed a portion of the depreciation claimed by the taxpayers in computing their rental income from the Chicago property in each of the years 1961, 1962 and 1963. (I-R. 58.)

On June 26, 1961, Harold J. and Beulah F. Graves filed an application for tentative carryback adjustment showing a 1960 net operating loss of \$12,855.97 carried back to 1957, generating a claimed 1957 refund of \$6,207.02. The 1957 refund was allowed on July 27, 1961 in the amount of \$6,207.02, plus interest of \$182.72. A revenue agent was then assigned to audit the relevant years and on June 18, 1962 he issued a report involving the years 1957, 1959 and 1960 which, after adjustments, allowed additional refunds of \$1,583.66

and \$500 for the years 1957 and 1959, respectively. The audit report showed two adjustments for 1959 involving (1) a mine expense deduction and (2) the amount of a capital loss. The audit report contained the words "no change" as to all items of income for 1960. (I-R. 59.)

On or about October 26, 1962, Harold J. and Beulah F. Graves filed a claim for refund of their 1958 taxes in the amount of \$9,251. resulting from the carryback of a 1961 net operating loss. A revenue agent was assigned to audit the relevant years and on May 24, 1963 he issued a report concerning the years 1958 and 1961 allowing a refund of \$9,189.17, plus interest, for 1958. The audit report contained the words "no change" as to all items of income for 1961. (I-R. 59.)

The respective taxpayers filed petitions for redeterminations with the Tax Court (I-R. 1-10, 13-25) and, upon a trial of the case, that court sustained the Commissioner's determination that the useful lives of the respective buildings as of September 1, 1959 was thirty-eight years and that the useful lives of the components of the respective buildings was twenty-eight years (I-R. 66). The Tax Court entered decisions accordingly. (I-R. 76, 86.) Thereafter, the taxpayers filed petitions for review to this Court. (I-R. 87-89, 90-)

SUMMARY OF ARGUMENT

The Tax Court's factual conclusion, that the useful lives of the two industrial buildings which the taxpayers owned in part were thirty-eight years and the useful lives of the components therein were twenty-eight years, for the purposes of computing depreciation on those properties, is not clearly erroneous and is entitled to affirmance on review.

The resolution of such a factual issue necessarily involves the application of a legal standard. In the instant case the issue relates to the useful lives of the Chicago properties and the legal standard, as set out in Treasury Regulation 1.167(a)-1(b), Treasury Regulations on Income Tax (1954 Code), and upheld and reiterated in Massey Motors v. United States, 364 U.S. 92, 97, may be fairly stated as follows:

The useful life of an asset is that period over which an asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of income. There is no dispute as to correctness of this standard or to its applicability in the instant case; it is the same rule which the lower court properly applied in reaching its decision. This rule or test requires an evaluation of certain physical and economic factors. Both factors play an equally important role in resolution of the fundamental issue of useful life. The lower court was cognizant of those two categories and obviously considered both in evaluating the evidence and in reaching its determination, notwithstanding certain verbiage in its opinion.

In determining the useful life of the structure which is here in issue, the physical factors which are pertinent to that determination include the condition and construction of the property, its geographic location, the location of the building on the lot, and the facilities within the structure. In like vein, the economic factors which are relevant include the availability of a labor force, the accessibility of the property to public transportation, the general demands for such building, zoning and planning involved, the highest

and best use of the property, and the present and future potentials of the property. However, evaluations and appraisals of the fair market value of the property are not relevant to the determination of useful life.

The estimation of the useful life of a particular asset may be substantiated by the opinion of an expert witness qualified to evaluate both the physical and economic aspects of a particular asset. The witness of the Commissioner, Mr. Kenney, was qualified to render an expert opinion as to the useful lives of the subject assets. He was a mechanical engineer and had served as a valuation engineer with the Internal Revenue Service for nine years. Kenney's testimony was entitled to the weight which the Tax Court gave it since that testimony was an evaluation of both the economic and physical factors involved in formulating a conclusion as to the useful lives of the Chicago properties. That testimony was relevant to the legal standard applicable in the case and was sufficiently comprehensive to be given great weight in the court's determination.

The Commissioner was not precluded from adjusting the useful lives of the Chicago properties by reason of Revenue Procedure 62-91. The prohibition in that procedure applies, by its specific terms, only when the evidence clearly establishes that the class lives of the assets have been examined and accepted and the taxpayer has the burden of establishing this by a preponderance of the evidence. In the instant case, the Tax Court found that there was no evidence establishing that the internal revenue agents ever made a specific examination of the depreciation deduction taken by the taxpayers and accepted

their depreciation computations. That factual conclusion of the lower court is supported by the record and is not clearly erroneous.

ARGUMENT

I

THE FACTUAL CONCLUSION OF THE TAX COURT, THAT THE TWO BUILDINGS HAD USEFUL LIVES OF THIRTY-EIGHT YEARS AND THE COMPONENTS THEREIN HAD USEFUL LIVES OF TWENTY-EIGHT YEARS, IS CONSISTENT WITH WELL SETTLED PRINCIPLES OF LAW AND BASED UPON THE RELEVANT RECORD EVIDENCE, AND IS ENTITLED TO AFFIRMANCE ON REVIEW

A. Introduction

The principal issue involved in this cause is whether the Tax Court correctly found and held that the useful lives of the two Chicago buildings which the taxpayers owned was thirty-eight years and the useful lives of the components in these respective buildings was twenty-eight years for the purpose of computing depreciation deductions under Section 167 of the Internal Revenue Code of 1954 (Appendix, infra). Section 167(a) provides, in language substantially unchanged in over fifty years, that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, including a reasonable allowance for obsolescence, of either property used in a business or property held for the production of income.

The regulatory translation and ampliation of that section, the validity of which is not questioned, sets out some general guidelines for computing the depreciation allowance. Section 1.167(a)-1(a) (Appendix, infra), provides that:

The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property, * * *. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. * * * The allowance shall not reflect amounts representing a mere reduction in market value. * * * (Emphasis supplied)

While the governing statute has at no time defined the term "useful life" (Massey Motors v. United States, 364 U.S. 92, 97), Treasury Regulations on Income Tax (1954 Code), Sec. 1.167(a)-1(b) (Appendix, infra), sets forth relevant considerations for determining that life as follows: 4/

(b) Useful life. For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage

4/ The term "useful life" was first inserted in the pertinent statutory provision in the Congressional enactment to the 1954 Code Section 167(b)(4). The accompanying House Report to the bill, H. Rep. No. 1337, 83d Cong., 2d Sess., p. 22 (3 U.S.C. Cong. & Adm. News (1954) 4017) stated:

Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is issued in a business. The annual deduction is computed by spreading the cost of the property over its estimated useful life.

value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

Depreciation has been characterized as the "reduction of the asset by wear and tear throughout its useful life in the business: as constituting, in theory, 'a gradual sale'; and as requiring a corresponding adjustment downward in original cost". United States v. Ludey, 274 U.S. 295, 300-301. It is settled that "the primary purpose of depreciation accounting is to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use * * * of the asset to the periods which it contributes." Massey Motors v. United States, *supra*, p. 104. In effect, the purpose of depreciation accounting is "to approximate and reflect the financial consequences of the subtle effects of time and use on the value of his capital assets. For this purpose, it is sound accounting practice to annually accrue * * * an amount which, at the time it is retired, will, with its salvage value, replace the original investment therein. Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101. See also Virginian Hotel Co. v. Helvering, 319 U.S. 523, 526, 528.

In computing the useful life of an asset, it is equally settled that life must be related to the period for which the asset may reasonably be expected to be useful to the taxpayer in his business or in the production of income. Massey Motors v. United States, supra, p. 107.

B. The court below recognized and applied the legal standards reflected in the pertinent regulations and judicial decisions and was well justified in rejecting the testimony of the taxpayers' expert witness in support of a 25 year useful life

As reflected in the authorities heretofore discussed, the length of the useful life of property used in a taxpayer's business, for purposes of depreciation deductions with respect to federal income taxes, is the period over which, on the basis of all relevant information it appears that the particular taxpayer is likely to continue the use of the property in the production of his business income. This was recognized by both parties and by the court below. The taxpayers seem to complain that the Tax Court ignored entirely the testimony of their expert witness, Walther. This is obviously incorrect since the court pointed (R. 65) to the statements of that witness in which he agreed with the testimony of the Commissioner's expert witness. At most, the court rejected the conclusions of the taxpayers' witness in so far as they were relied on to justify a material reduction in the useful life of the property to these taxpayers, as opposed to the corporation, on the ground that there were certain aspects of the physical structure of the buildings which might cut short their otherwise productive life as used by the corporation and as testified to by the Commissioner's expert witness. The court's comments in

this respect, we concede, are not entirely clear but, we maintain, the court was, on this record, entirely justified, and indeed compelled, to reject the taxpayers' argument, based upon their witness's testimony as to so-called economic useful life, that they were justified in 1959 in reducing to 25 years the substantially longer useful life theretofore used by the corporation as the period over which it believed it would profitably use the building--an estimate the correctness of which the taxpayers do not challenge.

The theory upon which the taxpayers seek to justify this curtailed useful life (Br. 22-27) is that the property had a shorter useful life in their hands, as lessors, than it did in the hands of the corporation as the user of the property. See also testimony of their witness. (I-R. 87-88.) This is manifestly incorrect. The taxpayers argue that as lessors they had to secure a rental which provided a profit margin to them--which we do not contest. Their error lies in assuming as a conceptual predicate (Br. 22-27) that the underlying physical factors which will determine how long a business (here, that of the corporation) will use a given plant as owner are different than those which will govern either its willingness to continue use of the same plant as lessee, or the lessor's willingness to permit that use to continue. There is no authority for this novel proposition (taxpayers cite none) 5/ and the obvious reason for that is the patent error of the self-serving concept that a given property has a different (shorter) useful life in the hands of one holding it for lease than in the hands of the actual user.

5/ Heart of Atlanta Motel, Inc. v. United States, decided March 15, 1963 (63-1 U.S.T.C., par. 9402), cited by taxpayers (Br. 23) involves the useful life of property used in the motel business of the owner.

The taxpayers attempt to support their theory on the ground that a lessor must receive a profit on the arrangement. They err, however, when (without discussion) they make the assumption, essential to their theory, that for that reason, an owner can afford to use the property in his business longer than a lessor-owner could afford to lease that same property to him. The owner-user is motivated by the same profit seeking which controls the lessor and will continue to use in its business property owned by it only so long as that use represents as great a return as can reasonably be expected from the property. 6/ When substantially greater overall profits inherent in a different use of the property can be realized by (1) selling it (cf. the underlying events in Fribourg Nav. Co. v. Commissioner, 383 U.S. 272) or (2) razing the improvements then on the land, constructing other improvements of more promising rental value and holding it for lease to others, we need scarcely point out that this is what will be done-- just as a lessor would do. 7/

Approaching the question from another direction, the taxpayers contend that the lessor must, in order to continue holding a property for lease, realize an acceptable profit from the rentals over and above the annual loss in value from depreciation. They maintain

6/ The highest and best use concept discussed by the witnesses.

7/ E.g., the owner of a large piece of downtown property on which he has for years operated a hamburger stand, but which now has greater and growing income potential, based on location advances, as a site for an office building, etc. is not going to continue long to operate his hamburger business on that site. He will either discontinue that business or move it to a new site and either sell the land outright at its inflated value or, himself, erect thereon the new structure and hold it for the profitable leases available.

further, apparently, that, at the operating utility and efficiency of the building for the purposes of the lessee-user decreases, the rental it is willing to pay will also diminish until finally the point is reached at which the available rental will be so low that it is no longer sufficient to recoup for the lessor the annual loss of his invested principle through depreciation plus the profit margin which he requires to justify the continuation of the investment (i.e., the return for the use and tying up of his principal) and the lessor will not continue to hold it out for lease. The taxpayers entire contention rests on the erroneous assumption that, when the property is owned by the business which is using it, the latter requires a benefit from the holding and use of the property only sufficient to recoup the loss in value from depreciation but not to cover this profit margin and, thus, can profitably hold and use it for a longer period than if it were leasing the property to another. The benefit reaped by the business, of course, is the business profit which use of the property (whether as owner or lessee) enables it to achieve. In either capacity (owner or lessee), it can economically (from the viewpoint of effective competition with others in its business) allocate only a given amount to the total costs of the particular business function for which it will employ the property in question. 8/ That maximum cost will necessarily cover all the costs of carrying on that function;

8/ Here, the function was that of a Chicago distribution center, sales office and research and development center. (I-R. 55-56.)

that is, it will cover both the cost of the right to use the building (whether as owner or lessee) plus any labor or other costs required to achieve the desired results from the building. The taxpayers argue, and we do not disagree, that, to the extent that undesirable design characteristics of a given building 9/ require the user to incur additional labor costs to carry out the desired function, the amount which can be profitably allocated to the cost of the bare right to use the building itself (e.g. the rental) is reduced accordingly. Again we say, however, that this is true whether the user acquires that right to use the building through a lease or through its own ownership and the rising labor costs cited by the taxpayers (Br. 25) as the factor which will ultimately reduce the rental value of the property to the point where a lessor would have to withdraw it from the leasing market will, at the same time, and for substantially the same reasons, shown below, force the user who also owns the property to dispose of it and replace it.

When the operator of a business purchases business property, it invests and ties up principal which it could otherwise use elsewhere to produce profit. A business elects to lease, rather than purchase, when it prefers not to make that investment but to use the required principal for other at least equally profitable purposes. That is the nature of the judgment involved as between purchasing or leasing; certainly, the operators of the business do not choose to lease in order to incur unnecessary costs or to make a gift to the lessor of

9/ Here, the taxpayers and their expert witness primarily cite the fact that the premises in question were of two story construction and without an elevator, thus requiring additional manpower.

the profit factor involved in the stipulated rental. When an election to purchase is made, 10/ the business user must forego the profit, or equivalent benefit, 11/ which it could have received from investment elsewhere of the cost of acquisition. Consequently, in order to continue economically and efficiently to hold and use the property in question as owners, the business user-owner would have to receive business benefit from its use in amount or value sufficient to cover both the loss of principal through depreciation plus the loss of the value of using the invested principal for other income producing purposes. Specifically, when the cited increasing costs of labor rose to the point where they, plus the bare cost of the right to use the instant premises (depreciation plus the annual income value of the principal tied up in its ownership) exceed the cost of, e.g., carrying out the business function by leasing other suitable property, the logical, common-sense, business move would be, just as in the case of the lessor, to liquidate the investment in the property by sale and to acquire or lease other property. Consequently, the above theory, upon which the taxpayers seek to justify the marked reduction in useful life from that used by the corporation is totally fallacious, as well as without supporting authority.

In addition to the above, the testimony of the taxpayers' expert witness is incapacitated because addressed to an hypothetical situation not found in the record facts of this case. His 25 year

10/ An election not to sell has the same effect, of course.

11/ By equivalent benefit, we mean, e.g., the saving of the cost of leasing other types of needed business property which it may have been enabled to purchase with the proceeds of the sale of the instant property.

estimate is based on the leasing prospects where it would be necessary to find tenants in the open market to whom the design of the buildings in question would be acceptable in light of the rental required. But, here, the design was concededly well suited to the needs of the existing tenant which had gone on record as having the intent and expectation of using the property in its business for a substantially longer period than the witness' 25 year estimated life. The following facts are here significant.

The first of the two parcels was acquired in 1951; the corporation (the existing tenant) built a single-story structure thereon in 1952 and in 1954 (just five years before the transfer to the taxpayers) itself added the second floor. (I-R. 55-56.) If that second floor represented a disadvantage of its intended business use of the premise the corporation went to great trouble and expense to handicap itself. With free opportunity to design the new structure best to suit its needs, the corporation elected the existing design. Had it regarded an elevator as advantageous, or its lack as built-in obsolescence, we may assume it would have installed one.

Next, it purchased in 1958 (just one year before the transfer) the second parcel which had an existing two-story structure thereon. Again, we may assume that if this design was not suitable to its needs, it would not have purchased this property at the substantial price paid. 12/ Moreover, it recorded an intended use of these buildings in its business for a period of from 34 to 40 years. Significantly, at the time all of this was being done by the corporatio

12/ Note that only a small fraction of the cost was for the land. (I-R. 3.)

Harold Graves (one of the taxpayers herein) was first president of the corporation and a member of its board of directors and then chairman of the board. (I-R. 57.)

From all of this, it is apparent that the building were regarded by the corporation as eminently suited to its needs and that it anticipated using them in its business for a period substantially longer than the useful lives adopted by the taxpayers as lessors. Indeed, the taxpayers themselves concede (Br. 18) that the structural characteristics cited by their expert witness as the basis of his view that they represented an obsolescence factor did not adversely affect the use by the corporation. The witness' opinion, being based on the hypothesis that the structural design represented a significant disadvantage to a tenant, obviously is irrelevant with respect to prospective continued use by Sawyers, Inc.--the present and probable future tenant.

Recognizing this, the taxpayers self-servingly conjecture that the corporation will not renew because (Br. 26-27) it is not legally obligated to do so. But probabilities are what fixes useful life and certainty is not required. The taxpayers seek to attach great significance to the fact that, with its latest lease renewal for the period ending 1969, the corporation took an option upon a further five year period until 1974 at the same rental, rather than take a lease for the full ten year period as allegedly offered by the lessors. In support, they cite the testimony of one of the taxpayers, Harold Graves, who conjectured that the reason was that "They didn't want to become obligated for a ten year lease, naturally." Apart from the

doubtful competency of Graves to testify to the motivations of the corporation, the statement is innocuous, even if taken as true, since a wish to lease only on five-year bases had marked the corporation's practice from the time of the 1959 transfer and each had contained an option for a further five-year period. (I-R. 5.) Moreover, with respect to the corporation's obvious continued satisfaction with the design of the building, although the taxpayers' position (and the testimony of their witness) is based upon a projected declining rental value for the property, we note that the corporation exercised its option for the second five-year period ending 1969 at an increased rental. 13/ The corporation's probable intent to renew again for the next five-year period is manifested by its willingness to invest the \$15,000 option price, which may well have been regarded by it as the cost to it of assuring no further increase of rental rate during that period in the face of a steadily rising rental market. Certainly Graves' self-serving and totally unexplained comment (I-R. 56) that he fears the option will not be exercised is meaningless in the face of the facts. The only possible reason suggested for non-renewal would be the so-called "obsolescence" features which, it has already been shown and conceded, do not apply to use by Sawyers, Inc.

Further evidencing the reasonable expectation that Sawyers, Inc., would continue to lease the property (or that it would be leased in any event) is the taxpayers' willingness to acquire it in 1959 at the corporation's book value (I-R. 4) and their use of that figure

13/ And, since the use by Sawyers, Inc. is not in any way special or unusual, we may reasonably assume that other companies would find the design equally satisfactory to their purposes, if it became necessary to find a new tenant.

as their cost basis. The taxpayers contend (Br. 31-32) that the market value of the property was lower than the depreciated book value due to the fact that inadequate depreciation had been taken. If they really believed this, or that the useful life (and thus value) would be less in their hands than in the hands of the corporation, we submit, they would not have dealt with the corporation on these terms.

Since, on the record as discussed above, the taxpayer has shown no factual basis for a belief that Sawyers, Inc., will not continue to lease the property, or that the taxpayers will be faced with the need to find new tenants, the witness' opinion, based on a contrary hypothesis, is disqualified. Moreover, should it come to pass in the future that, for any reason, Sawyers, Inc., does not renew its lease, the design factors relied upon by the taxpayers' witness will for the first time become relevant and may then be taken into account in determining the then remaining useful life of the property and an appropriate adjustment made in the taxpayers' depreciation schedule.

We believe that the Tax Court was warranted in rejecting the 25 year life opinion of the taxpayers' witness for one further reason. That opinion rests virtually entirely on the fact of the two-story construction of the buildings and the lack of an elevator. The witness failed completely to mention or take into account the possibility 14/ that, should this situation at any time in the future prove to be a deterrent to further profitable leasing, it could, as any other problem of that nature, be remedied by (1) installation of an elevator or (2) knocking out the ceiling between the two floors so

14/ This may have been because the witness had no background as an engineer. (I-R. 45.)

as to create the situation (a high ceilinged one-floor structure) which the taxpayers' witness regarded as so desirable. This would, of course, add to the taxpayers' depreciable basis in the property but is no reason to ignore the then continuing use in the production of the taxpayers' income of the original structure, the cost of which must be allocated to the years in which it would be used following the modification as well as the years prior thereto. 15/ In short, proper estimation of the useful life of the property must take into account the additional period of usefulness of the original investment which would result from such modification and the failure of the taxpayers' witness to do so constitutes use of an improper standard and invalidates his opinion testimony.

In any event, we call the Court's attention to the fact that to the extent the taxpayers' witness relied upon economic theories of obsolescence to justify a 25 year useful life on the buildings, this has no relevance to the question of the proper useful life of the physical components of the buildings since both expert witnesses predicated their estimates of useful life on the full physical utility of those components, not upon any economic obsolescence. On this factual controversy, the Tax Court obviously adopted the estimates of the Commissioner's witness.

15/ It is worth noting here, in connection with taxpayers' theory (Br. 23) that the location might outgrow the building that, as of August 31, 1959, of the total book value of the properties of \$592,057.67, only \$41,623.38 was allocated to the land itself (to which value resulting from location must accrue) with the balance being allocated to the structures. This book value reflects the actual market values established by the purchases and construction just a few years earlier. (I-R. 3-4.)

C. The Tax Court's findings, based upon the entire record, are not clearly erroneous and entitled to affirmance

The issue at hand, being the useful life of the subject assets, is basically factual and the lower court's finding with respect to it are entitled to affirmance unless clearly erroneous. Estate of Bryan v. Commissioner, 364 F. 2d 751 (C.A. 4th); Dinkins v. Commissioner, 378 F. 2d 825 (C.A. 8th). It is clear that the taxpayers have the burden of proving by a fair preponderance of the credible evidence that the determination of the Commissioner is erroneous. Southeastern Bldg. Corp. v. Commissioner, 148 F. 2d 879 (C.A. 5th); Warnecke v. United States, 256 F. Supp. 800 (S.D. N.Y.); Bay Sound Transportation Co. v. United States, decided April 30, 1967 (20 A.F.T.R. 2d 5418). We have already shown the deficiencies in the testimony of the taxpayers' expert witness and that the Tax Court correctly rejected it. Therefore, the taxpayers have failed to meet that burden and decision for the Commissioner followed, of necessity.

However, if more were required, the Commissioner's determination, and the holding of the Tax Court, was fully supported by the testimony of the expert witness, Kenney. He was a "valuation engineer" with the Internal Revenue Service, having received a college degree in mechanical engineering and been registered as a professional engineer in the State of Kentucky. (II-R. 67-68.) He had been involved in the examination of buildings and properties throughout the entire Chicago metropolitan area for about nine years for the Internal Revenue Service. (II-R. 67, 68.) He had, on prior occasions,

testified before the Tax Court as an expert for the purpose of determining useful lives. (II-R. 68-69.) Kenney was not only familiar with the subject properties by reason of having viewed the area in the past but made an examination of the subject properties for the specific purpose of determining their useful lives as of September 1, 1959. (II-R. 69, 70.)

Kenney stated that in his opinion the useful lives of the buildings were thirty-eight years, and further stated that the useful lives of the components were twenty-eight years as of September 1, 1959. (II-R. 71.) Kenney stated that he considered certain factors in arriving at his determinations, and that among these were the location of the property, accessibility to public transportation, conditions and constructions, the location and position of the buildings on the lot and property, facilities within the structure, availability of labor force, general demands of such building, zoning and planning involved, and most assuredly the present and future potentials of the property. (II-R. 71-72.) Kenney expressed his opinion as to each of those factors as they related to the subject properties, and in each instance, his opinion supported his estimates of useful lives. (II-R. 72-82.)

Kenney's specific responses to those various factors may be summarized as follows: The properties were located in an excellent area (industrial) (II-R. 72), and easily accessible to public transportation (II-R. 75). The condition of the buildings "was

'exceptionally good.' The construction was modern and the buildings had proper loading docks and facilities for general light industrial activities. (II-R. 76.)

The land was utilized to its highest and best use by arrangement of the property as it was. (II-R. 78-79.) By this Kenney meant that best use of land was to have an industrial building on it. (II-R. 83.) Both properties had good arrangements for the activities they were in at the particular time 15/ and could be rearranged for any office work or other like manufacturing as would be necessary. (II-R. 80.) There was adequate availability of a labor force necessary to Sawyers or any other lessee of the taxpayers. (II-R. 80.) Buildings of the type that are in issue were in great demand throughout the Chicago area. (II-R. 80-81.) Kenney's opinion in sum was that the buildings were located in an excellent area, so good, that "none other in Chicago that can rate with it." (II-R. 81.) It had great possibilities for utilization as office space, warehouse space, light manufacturing, particularly electronics, and other assembly operations. (II-R. 81.) The taxpayers' expert witness acknowledged that he agreed with much of Kenney's testimony. (II-R. 85.)

1. The Tax Court was correct in deciding that the Commissioner's witness, Mr. Kenney, had the qualifications to render an expert opinion as to the useful lives of the subject properties

We submit that Kenney was qualified to render an expert opinion, i.e., to testify as an expert witness, on the issue at hand, and the 15/ Kenney later elaborated upon his statement that the property had good arrangement. (II-R. 83.) He stated that this term meant "The arrangement of the property, lay of the buildings, * * * such as the loading docks with reference to their distribution and use of the building." (II-R. 83.)

Tax Court, in the exercise of its function as the trier of facts, properly accepted his testimony.

It is well settled that the question of whether a witness called to testify to a matter of opinion has such qualifications and knowledge as to make his testimony admissible on the issue in controversy is a preliminary question for the trial judge and his decision of it is conclusive, i.e., should not be reviewed on appeal unless clearly shown to be erroneous as a matter of law. Turner v. American Security & Trust Co, 213 U.S. 257; Stillwell Manufacturing Co. v. Phelps, 130 U.S. 520.

To determine whether the Commissioner's witness had the necessary qualifications to render an expert opinion on the issue at hand, it is necessary to view his qualifications against that issue and the tests or factors employed to resolve it. Here, we are concerned with the period the Chicago properties may reasonably be expected to function profitably in the taxpayers' business of leasing the structures. The Treasury Regulations on Income Tax (1954 Code), §1.167(a)-1(b), sets out certain factors which may be considered in determining this period. Those factors, in so far as here relevant, include, (1) wear and tear, decay and decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current development within the industry and the taxpayers' trade or business, and (3) the climatic and other local conditions peculiar to the taxpayers' trade or business.

The Commissioner's expert witness was eminently well qualified to render an expert opinion on the useful lives of the subject assets as used in the taxpayers' business based upon the above factors. Kenney was formally educated in mechanical engineering, had served for nine years as a valuation engineer with the Internal Revenue Service and had testified in prior Tax Court proceedings with respect to useful life. (II-R. 67-69.)

Moreover, the taxpayers did not, at trial, challenge the qualifications of Kenney to give the testimony here in question. Counsel questioned only the witness' qualification to testify about "economic useful life." (I-R. 70-71.) However, he made no objection when the witness discussed such relevant matters as the general demands of such building (I-R. 80-81), the present and potential use of the property (I-R. 81), the location, size and utilization of the inside space (I-R. 78-79), and the zoning and planning involved (I-R. 81).

2. The Tax Court properly refused to admit the appraisal report dealing with the fair market value of the Chicago buildings on a date subsequent to the years in issue

The Tax Court refused to admit in evidence an appraisal report on the 1964 fair market value of the Chicago properties. (II-R. 38.) We submit that the lower court was entirely correct.

It is clear that evidence of fair market value has no relevance to the determination of useful life. It is only relevant in the determination of the adjusted basis of property subject to the

allowance for depreciation and in the determination of salvage value.

Estate of Bryan v. Commissioner, supra. As the Court of Appeals stated in Estate of Bryan, supra, p. 753, "[The] mere fact that, at the midlife of an asset, its basis is either higher or lower than its market value, indicates nothing so far as we can see about the accuracy of the useful life estimate."

The taxpayers' reliance (Br. 31) upon Fribourg Nav. Co. v. Commissioner, supra, is entirely misplaced in that, among other reasons, the taxpayers represent it as having passed upon the rules governing useful life, whereas that case was concerned only with the question of the proper salvage value--a completely independent question. In sum, the opinion held only that the fact that an asset had been sold for a price in excess of its adjusted basis in the year of sale did not alone indicate that the salvage value originally set up at the time the asset was acquired was unreasonable and entitle the Commissioner to deny a depreciation deduction for the year of sale. Not only are the taxpayers in error in claiming authority in that case for the proposition that "fair market value above depreciated basis is evidence of a miscalculated economic useful life", or any other kind of useful life, that decision and the appellate court decision therein approved (see e.g. United States v. S & A Co., 338 F. 2d 629 (C.A. 8th)) hold that fair market value in the middle of an asset's useful life is no evidence of anything (cf. the holding in Estate of Bryan, supra) and a comparison thereof with the then adjusted basis is not even evidence that the estimated salvage value

16/ Treasury Regulations on Income Tax (1954 Code), Section 1.167(a)-1(b) specifically provides that "Salvage value is not a factor for the purpose of determining useful life."

(which has a specific relationship to market value, whereas useful life has none) was unreasonable or incorrect. Consequently, the taxpayers' arguments, based on this specious construction of Fribourg, supra, are unsound and the Tax Court's refusal to admit the report into evidence was entirely correct.

II

THE TAX COURT WAS CORRECT IN CONCLUDING THAT THE COMMISSIONER'S ADJUSTMENTS OF THE USEFUL LIVES OF THE CHICAGO PROPERTIES FOR DEPRECIATION PURPOSES WAS NOT PRECLUDED BY REV. PROC. 62-21 OR ANY PRIOR REVENUE RULING

Immediately before the start of the trial before the Tax Court, the taxpayers amended their petitions to allege that the Commissioner was precluded by Rev. Proc. 62-21, 1962-2 Cum. Bull. 418, from disturbing the depreciation deductions claimed by them in the Chicago properties. (I-R. 59.) They argued below and contend on brief before the Court that the useful lives assigned to the buildings in Chicago, as well as the components of such buildings, were accepted by the internal revenue agents within the meaning of subsection 3.05 of Part II of the Rev. Proc. 62-21. (I-R. 60.)

Rev. Proc. 62-21, which was promulgated in July of 1962, and not made retroactive, represents a basic reform in the procedures and standards to be followed in computing depreciation for the purposes of taxation. This revenue procedure, replacing the Bulletin F guidelines, Rev. Rul. 90, 1953-1 Cum. Bull. 43 and Rev. Rul. 91, 1953-1 Cum. Bull. 44, supplies new guidelines for broad classes of assets which, generally, permits a more rapid depreciation of assets. The

unique feature of the new revenue procedure is that it employs a mechanical test, the reserve ratio test, to determine the appropriateness of depreciation deductions taken by a taxpayer. The reserve ratio test is an objective technique for establishing that a taxpayer's retirement and replacement practices for a guideline class of assets are consistent with the class life he is using.

Part I of the revenue procedure provides guideline lives for broad classes of assets; Part II contains a detailed description of procedures to be followed in examining depreciation deductions. Subsection 3 of Part II describes the procedures to be followed when the taxpayer's class life is shorter than the prescribed guideline lives. This is the problem attendant in the instant case.

Subsection 3.05 of Part II, the only subsection of the revenue procedure which is in issue, provides as follows:

.05 Subsequent use of class life previously justified.--Where the class life used by a taxpayer was examined by the Internal Revenue Service and was accepted by reason of subsection .02, .03, or .04 of this section, or where such class life was accepted on audit by the Internal Revenue Service under presently established procedures for examining depreciation (whether before or after the effective date of this Revenue Procedure), the depreciation deduction claimed by the taxpayer for the assets in that class in any subsequent taxable year based on that class life will not be disturbed if the taxpayer's retirement and replacement practices for that class are consistent with the class life being used. This consistency may be demonstrated either by the reserve ratio test set forth in section 5 of this Part or by all the facts and circumstances.

Subsection 3.05 then goes on to state that the "previously justified" class life will not be questioned during a period of three years in

order to give taxpayers an opportunity to conform their retirement and replacement practices with the class life being used. It provides that:

The reserve ratio test is a technique for establishing objectively that the taxpayer's retirement and replacement practices for a guideline class are consistent with the class life he is using. If the test is met, the depreciation deduction for that class will not be disturbed. In order to give taxpayers an opportunity where needed to conform their retirement and replacement practices with the class lives being used, the reserve ratio test will be considered to be met for the first three taxable years to which this Revenue Procedure applies. The previously justified class life will not be questioned during that period. Thereafter, if the test is not met, a taxpayer may by the use of presently established procedures demonstrate that his retirement and replacement practices are consistent with the class life being used.

On the basis of the record evidence, the Tax Court found and so held (I-R. 62-63) that the class lives used by the taxpayers was not examined or accepted on audit by the Internal Revenue Service and, therefore, the Commissioner was not precluded from later adjusting the useful lives of the Chicago properties for the years 1961, 1962, and 1963. We submit that this conclusion is supported by the record and entitled to affirmance.

It is clear that a class life will be considered "accepted on audit" under subsection 3.05 when the evidence establishes that the class life has been specifically examined and accepted. Question 49 of the interpretative questions and answers that accompany Rev. Proc. 62-21, 1962-2 Cum. Bull. 477, serves to firmly establish that this is the correct interpretation of that subsection. That question

interprets the phrase "accepted on audit", used in subsection 3.05, as covering all situations in which the audit report shows adjustments to class life or contains comments that it was examined but not adjusted, or where other specific evidence indicates that the class life was examined. The record in the instant case is devoid of any evidence whatsoever establishing that there was a specific audit, or examination of any sort, of the taxpayers' depreciation deductions on the Chicago property within the meaning of subsection 3.05 of the revenue procedure.

In the lower court, the burden of proof was, of course, upon the taxpayers to establish, by clear and convincing evidence, that the useful lives of the Chicago properties was 'accepted on audit' within the meaning of subsection 3.05 of the revenue procedure; because this issue is basically one of fact, the taxpayers must now establish that the Tax Court's factual findings with respect to this issue are clearly erroneous. Commissioner v. Duberstein, 363 U.S. 278. The evidence, however, clearly supports the conclusions of the lower court.

Taxpayers Harold and Beulah Graves, under letter dated June 26, 1961, filed an application for a tax refund based upon a tentative net operating loss incurred in 1960 and a carryback adjustment to the taxable year 1957; this carryback and refund were allowed. (I-R. 37, Stip., par. 13.) Revenue Agent Andrews audited the claim and issued audit reports concerning the taxable years 1957, 1959, and 1960. (I-R. 37, Stip., par. 14.) In 1962, the same taxpayers filed a

claim for refund of 1958 taxes generated by another net operating loss in 1961 and an attendant carryback to the year 1958. Revenue Agent Miller audited the refund and issued an audit report concerning the years 1958 and 1961. (I-R. 37, Stip., par. 15.) The two audit reports, one covering the years 1957, 1959 and 1960 and the other covering 1958 and 1961, were introduced in evidence but as the Tax Court correctly found (I-R. 62), "neither one * * * [contained] the slightest comment or any other 'specific evidence' that the depreciation deductions on the Chicago property (acquired in September 1959), as shown on the returns of Harold J. and Beulah F. Graves were examined." The audit reports indicated merely that no changes had been made since both reports had printed on them the words "no change". (I-R. 59.) Moreover, there was no occasion, or opportunity, for the agents making the audits to examine the property since the audits were performed in Portland, Oregon, and the property was located in Chicago; there was no evidence that those agents ever requested a collateral investigation of the property. Finally, although both agents were present at trial and willing to testify with respect to their audits, the taxpayers never questioned either one, in open court, on this subject. (I-R. 63.) The Commissioner here maintains that a "no change" result after audit frequently means that a particular item has been accepted, for that year and at that particular time (subsequent re-audit of the same return might go into it more closely), without examination. The taxpayers simply choose, without supporting evidence or authority, to assume the contrary--i.e., that an

examining agent never indicates "no change" with respect to any item unless he has specifically examined not only it but every underlying or contributing item. The taxpayers, having the burden of proof in this case, had the opportunity to obtain the best evidence as to the practices on audit with respect to this, in general, or the specific scope of the audit in the instant case, yet failed to do so. Having so failed, they should not be allowed to attach any greater significance to the otherwise uninformative notations on the reports. Were there merit in the taxpayers construction, we may assume that the revenue procedure would have conferred finality upon the mere appearance of the words "no change". Instead it was required that an actual examination have been made and the taxpayers have failed to show this.

In addition, and aside from the above considerations, we submit that the revenue procedure has no application to the subject audits made with respect to the calendar years 1960 and 1961 (I-R. 59), since that procedure, by its express terms, does not apply "to examinations of depreciation claimed for taxable years for which returns were due to be filed before July 12, 1962." 1962-2 Cum. Bull. 429, fn. 2. In the instant case, the alleged examinations were made on returns due to be filed prior to July 12, 1962. The examinations were made with respect to the years 1960 and 1961. (I-R. 59.) And it is certain that the taxpayers' return for 1961, the latest year audited, was due on or before April 15, 1962, (Section 6072(a), Internal Revenue Code of 1954), which is prior to the date of the revenue procedure, July 12, 1962.

In any event, since it is undisputed that the tax returns of Vernon and Theodora Graves were never audited, these taxpayers cannot claim the application of the revenue procedure to them by reason of the audit of Harold and Beulah Graves' returns.

CONCLUSION

For the reasons stated above, the decisions of the Tax Court are correct and should be affirmed on review.

Respectfully submitted,

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DECEMBER, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of _____, 1967.

Robert I. Waxman
Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) General Rule.--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

- (1) of property used in the trade or business, or
- (2) of property held for the production of income.

(b) Use of Certain Methods and Rates.--For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

- (1) the straight line method,
- (2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),
- (3) the sum of the years-digits method, and
- (4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

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Treasury Regulations on Income Tax (1954 Code):

§ 1.167(a)-1 Depreciation in general.

(a) Reasonable allowance. Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) Useful life. For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in

the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

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(26 C.F.R., Sec. 1.167(a)-1.)

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

VERNON KEITH GRAVES and
THEODORA GRAVES,

Appellants,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Appellee.

HAROLD J. GRAVES and BEULAH
F. GRAVES,

Appellants,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Appellee.

FILED

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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

VERNON KEITH GRAVES and
THEODORA GRAVES,

Appellants,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Appellee.

HAROLD J. GRAVES and BEULAH
GRAVES,

Appellants,

v.

COMMISSIONER OF INTERNAL
REVENUE,

Appellee.

APPELLANTS' REPLY BRIEF

Commissioner Recognizes Tax Court Gave Invalid Reason
for Disregarding Obsolescence but Endeavors to Salvage
Decision by Advancing New Theory Lacking Factual Support

No objection is voiced in the Commissioner's brief to the actuality of the obsolescence features cited by petitioners' expert witness as the basis for his testimony supporting a 25 year economic useful life for the Chicago Buildings. Although the Commissioner concedes the obsolescence features have an adverse impact if tenants must be sought on the open rental market, he claims the features do not affect economic useful life

of petitioners because petitioners are assured of retaining Sawyers, Inc. as a tenant for substantially longer than 25 years. (Br. 19-20)

Such contention of the Commissioner is no sounder than the evidence supporting the assertion that petitioners can count upon retaining Sawyers, Inc. as a tenant for substantially longer than 25 years. Completely lacking is any finding of the Tax Court on the anticipated length of Sawyers, Inc.'s tenancy. The Tax Court rejected the testimony of petitioners' expert witness concerning the obsolescence features, not because Sawyers, Inc. was an assured tenant, but because the testimony was directed to an erroneous (in the eyes of the Tax Court) definition of economic useful life involving factors deemed irrelevant by the Tax Court, such as highest and best use of the land and market reaction. (R. 65-66)

The Commissioner tacitly accepts the definition of economic useful life upon which petitioners' expert witness based his obsolescence testimony,¹ and acknowledges the materiality

¹ The Commissioner evolves the following definition of economic useful life from the authorities reviewed by him (Br. 14): ". . . the period over which, on the basis of all relevant information, it appears that the particular taxpayer is likely to continue the use of the property in the production of his business income."

The definition used by petitioners' expert witness as the basis for his testimony was:

How long it takes before the return on the land plus the building would be no more than the return on the land alone.

Obviously, a taxpayer is not likely to continue the use of a rental building beyond the time the return on the land plus the building is no more than the return on the land alone, so there is complete compatibility between the definitions of economic useful life.

materiality of economic factors such as whether a rental building constitutes the highest and best use of the land.² This amounts to recognition by the Commissioner that the Tax Court gave an invalid reason for disregarding the obsolescence features. Nevertheless, the Commissioner endeavors to salvage the decision on the ground that a similar result is dictated by the new theory advanced in his brief, i.e., - the obsolescence features have no impact upon determination of economic useful life for petitioners because petitioners can count upon retaining Sawyers, Inc. as a tenant for substantially longer than 25 years.

As sole evidence of petitioners' ability to retain Sawyers, Inc. as a tenant for substantially more than 25 years, the Commissioner points to the fact that the economic useful life assigned the buildings by Sawyers, Inc. for depreciation purposes had 33 years to go when petitioners acquired the buildings on September 1, 1959 and leased them back to Sawyers. (Br. 20-21) According to the Commissioner, this constituted a manifestation that Sawyers, Inc. not only could but would profitably use the buildings for substantially more than 25 years. (Br. 15 and 21) Petitioners acknowledge Sawyers, Inc. should be regarded as an assured tenant during such period

²Footnotes 6 and 7 (Br. 16) and the text to which they relate. The Commissioner cites with approval (Br. 25) the case of Warnecke v. United States, 256 F. Supp. 800 (S.D. N.Y. 1966) containing as a material finding the fact that the building in question "represented the highest and best use of the underlying land." (256 F. Supp. 802). A building which represents the highest and best use of the land on a given date will naturally have a longer economic useful life than one which does not.

as the evidence shows Sawyers could and would profitably use the buildings. Where petitioners and the Commissioner part company is over the question of whether the assignment of economic useful life to the buildings by Sawyers, Inc. for depreciation purposes establishes that Sawyers, Inc. could and would profitably use the Chicago Buildings for substantially longer than 25 years from September 1, 1959.

Sawyers, Inc. made its determination of economic useful life prior to the decision of the Supreme Court in Massey Motors v. United States, 364 U.S. 92 (1960). At that time, many informed taxpayers thought economic useful life was the full abstract life inherent in the general class of property, rather than the economic useful life of the particular property as employed in the taxpayer's particular business. Even if Sawyers, Inc. is charged with knowing the law as announced in Massey Motors, supra, the designation of economic useful life should not be interpreted as assurance that Sawyers, Inc. could, much less would, profitably use the buildings for the assigned life. This is made clear by the following quotation from Massey Motors v. United States, supra at 96-7:

"In practical life, however, business concerns do not usually know how long an asset will be of profitable use to them or how long it may be utilized until no longer capable of functioning. But, for the most part, such assets are used for their entire economic life, and the depreciation base in such cases has long been recognized as the number of years the asset is expected to function profitably in use."

"Some assets, however, are not acquired with intent to be employed in the business for their full economic life. It is this type of asset, where the experience of the taxpayers clearly indicates a utilization of the asset for a substantially shorter period than its full economic life, that we are concerned with in these cases."

(Emphasis added)

As recognized by the Supreme Court in the above quotation, business concerns in practical life do not know how long an asset will be of profitable use, despite the necessity of making a guesstimation for depreciation purposes. Even if Sawyers, Inc. were an exception to the general rule and knew precisely how long it could profitably use the buildings in its business, assignment of an economic useful life does not evidence an intention to actually use the buildings for the full period of anticipated profitability. As the Supreme Court stated, some businesses, such as the taxpayer in Massey Motors, acquire assets with no intention of employing them for the full economic useful life.

When placed in proper perspective, the fact that the economic useful life assigned the buildings by Sawyers, Inc. had 33 years to run offers scant support for the Commissioner's assertion that Sawyers, Inc. anticipated using the buildings in its business for a period substantially longer than 25 years. If the useful life assigned the buildings by Sawyers, Inc. is any evidence on the subject, it does not survive the impact of more pertinent evidence. The lease was for only five years with a five year renewal option. Such form of the lease

reflected the desire of Sawyers, Inc., not petitioners, since a lessor prefers a firm ten year lease over a five year lease with a five year renewal at the lessee's option. It stands to reason that Sawyers, Inc. would not have insisted upon a five year lease with a five year renewal option if Sayers, Inc. really intended to lease the Chicago Property for more than 25 years.

Similar indecision on the part of Sawyers is evidenced by the renewal option granted on December 28, 1964 permitting an additional five years from September 1, 1969 to August 31, 1974. Sawyers, Inc. paid \$15,000 for the option which did not give Sawyers, Inc. the right to apply the \$15,000 option price against the rental in the event the option were exercised. If Sawyers, Inc. definitely intended to rent the buildings for more than 15 years after August 31, 1969 (as the Commissioner claims), Sawyers, Inc. would have executed a firm lease for at least the first five years of such period and saved the \$15,000 option price. Harold Graves testified that he had no expectation Sawyers, Inc. would exercise the option. The Commissioner dismisses the testimony of Harold Graves as self-serving. Who was in a better position to testify on the subject? Not only was Harold Graves the dominant owner of the Chicago Property, but he was president of Sawyers, Inc. when it acquired the buildings and was chairman of the board for two years immediately preceding transfer of the buildings to petitioners.

Although the Commissioner is quite right that an owner-user is motivated by the same profit seeking as controls a lessor (Br. 16), the impact of obsolescence features upon economic useful life may differ between an owner-user on the one hand, and an owner-lessor on the other hand, even when the same buildings are involved. Since the obsolescence features were initially acceptable to Sawyers, Inc. as owner-user, it might have been improper for Sawyers, Inc. to have taken them into account when determining economic useful life. The fact that the obsolescence features could be disregarded by Sawyers, Inc. as owner-user does not alter the situation faced by the petitioners. There are many reasons other than the effect of the obsolescence features why Sawyers, Inc. might decline to renew the lease. By divesting itself of the investment in the Chicago Buildings and leasing them back under a short term lease with renewal options, Sawyers, Inc. acquired the flexibility of being able to move when other buildings better serve future requirements. While the buildings were initially acceptable to Sawyers, Inc., it defies reality to assume that more than 25 years would elapse before Sawyers, Inc. could find buildings better suited to changing business needs. As previously pointed out, the Commissioner has never questioned the reality of the obsolescence or the 25 year economic useful life resulting therefrom if petitioners must seek tenants on the open rental market. Petitioners would have been hiding their heads in the sand if they had assumed Sawyers, Inc. could be retained

as a tenant for more than 25 years under a five year lease with a five year renewal at lessee's option. Ostrich-like behavior is not required in determination of economic useful life.

Commissioner Misinterprets the Context in Which Petitioners Offered the Appraisal Report Showing Fair Market Value of the Buildings

As authority supporting the Tax Court's refusal to admit the appraisal report showing the fair market value of the Chicago Buildings, the Commissioner cites Estate of Bryan v. Commissioner, 364 F. 2d 751 (4th Cir. 1966). The taxpayer in Estate of Bryan was not attempting to sustain the economic useful life assigned to the property by him. Through an amended petition in the Tax Court, the taxpayer was attempting to shorten the useful life previously established by him and obtain additional depreciation resulting therefrom. As primary support for the shortened lives, the taxpayer submitted a fair market value appraisal from which 30% was deducted as the "inflationary element" leaving a net figure substantially less than the depreciated basis generated by the original lives.

Under the fact situation of Estate of Bryan, the Court may have been justified in making the statement quoted by the Commissioner (Br. 30). Such is a far different context from that in which petitioners offered the appraisal rejected by the Tax Court. Petitioners are not deducting an inflationary element, and are not invoking fair market value as an affirmative weapon to obtain an additional depreciation deduction.

Petitioners merely assert the fair market value appraisal as a defense to depreciation disallowance initiated by the Commissioner.

Completely ignored by the Commissioner is the passage from Massey Motors v. United States, supra, quoted in petitioners' opening brief (p. 32) where the Supreme Court related that a purpose of the depreciation allowance is to protect taxpayers from a loss. By loss, the Supreme Court meant a loss other than one resulting from a downward fluctuation in property values. Upon tendering the appraisal showing the fair market values of the buildings on November 3, 1964, petitioners offered to negate any decrease in fair market value of the buildings from petitioners' date of acquisition on September 1, 1959 through November 3, 1964, attributable to a downward fluctuation in property values.³ When downward fluctuation in property value is negated, establishment of a fair market value below depreciated basis on a particular date shows that the depreciation taken to such date was insufficient to accomplish the avowed objective of protecting the taxpayer against loss. How, then, can the Commissioner be right in his determination that petitioners took excessive depreciation. Whether such establishment of fair market value (coupled with negation of any downward fluctuation in property values)

³As it turned out, negation of a downward fluctuation in property value was accomplished by the testimony of the Commissioner's expert witness concerning the excellence of the location which testimony is summarized on page 27 of the Commissioner's brief.

furnishes the positive defense asserted by petitioners, it nevertheless warrants due consideration, and the Tax Court erred in rejecting introduction of the appraisal.

In an effort to brush aside petitioners' citation of Fribourg Nav. Co. v. Commissioner, 383 U.S. 272 (1966), the Commissioner claims the case relates only to salvage value. (Br. 30) This is not an accurate interpretation. The case involved the whole depreciation package, - economic useful life as well as salvage value. Even if Fribourg Nav. Co. was limited to salvage value, anything pertinent to a determination of salvage value has like pertinency to a determination of economic useful life, particularly where (as here) no salvage value was assigned to the property and economic useful life is the only depreciation component.

The Commissioner Garbles the Best Evidence Rule in
an Effort to Avoid the Impact of Revenue Procedure 62-21

Although the Commissioner recognizes that the answer to Question 49 correctly interprets the phrase "accepted on audit" for purposes of triggering the prohibition of Subsection 3.05, part II of the Revenue Procedure 62-21, 1962-2 Cum. Bull. 433 (Br. 33-34), the Commissioner uses rather loose language in relating what the answer says. According to the Commissioner, the answer interprets the phrase "accepted on audit" as covering all situations in which the audit report shows adjustments to class life or contains comments that it was examined but not adjusted. (Br. 34) Such use of "it" obscures exactly what must be examined. A verbatim reading of the answer to Question

49 discloses that the key term is something quite different from the pronoun "it" having "class life" as the antecedent. The pertinent sentence from the answer to Question 49 reads as follows (with the portion thereof relied upon by petitioners being italicized):

"The class life used by a taxpayer will be considered to have been accepted on audit for purposes of applying the provisions of the Revenue Procedure in all situations in which *the audit report shows adjustments to depreciation or contains comments that the depreciation deduction was examined but not adjusted, or where other specific evidence indicates that the depreciation deduction was examined.*"

The depreciation deduction, not the property itself, is the thing concerning which the audit report must contain comment as to examination without adjustment.

Two different agents wrote the words "no change" opposite certain items on audit report schedules entitled "ITEM ADJUSTMENTS" (xerox copies at page 14 of petitioners' opening brief). The "no change" endorsement covered loss figures entered by the agents opposite "Rents and royalties" on the item adjustment schedules which loss figures were taken from depreciation schedules in the Graves' returns. These depreciation schedules show not only the total depreciation deductions, but the derivation thereof, including specification of the 25 year lives for the buildings and five year lives for the electrical, heating and plumbing portions of the buildings (xerox copy on page 12 of petitioners' opening brief). The covering letters under which the audit reports were enclosed

to the Graves expressly state that the reports reflect "examination" of the subject tax returns, and the first page of the reports identify the preparing agent as the "examiner."

It is petitioners' contention that the words "no change" written by an "examiner" on a schedule entitled "ITEM ADJUSTMENTS" contained in an audit report represented to reflect an "examination" of tax returns constitutes a pure and simple comment that the items, including the components thereof clearly set forth in the tax returns, were examined but not adjusted. Since this contention rests entirely upon written documentation (the audit reports and the tax returns) it would have been improper to offer supplementing oral testimony in the absence of ambiguity. Petitioners disclaim any ambiguity. The Commissioner must be under some misapprehension concerning the best evidence rule when he complains about petitioners' failure to supply the best evidence. (Br. 36)

Disregarding the documentary context in which the endorsements "no change" were made, the Commissioner accusingly states that petitioners ". . . simply chose, without supporting evidence or authority, to assume . . . that an examining agent never indicates 'no change' with respect to any item unless he has specifically examined not only it but every underlying or contributing item." What the Commissioner studiously overlooks is that the depreciation deductions were not obscure underlying or contributing items, but were clearly set forth on schedules attached to and made a part of the returns. In fact, the depreciation deductions were the largest single deductions in the Graves' returns.

Effect of Revenue Procedure 62-21 Upon 1960 and 1961

If the "no change" comments on the audit reports for 1960 and 1961 complied with the answer to Question 49, the Commissioner recognizes that he is precluded from making the adjustments for 1962 and 1963, but claims the prohibition does not affect 1960 and 1961 (Br. 36). Basis for this assertion is the provision in Section 1, part II, 1962-2 Cum. Bull. 429 that the procedures will be used in connection with the examination of income tax returns the due date for the filing of which is on or after July 12, 1962, and the due dates for filing 1960 and 1961 returns were prior to July 12, 1962.

Subsection 3.05 expressly states that the audit report accepting the class life may have been made before the effective date of the revenue procedure, and expressly precludes the disturbing of depreciation for any subsequent taxable year. There is no limitation in Subsection 3.05 to only those subsequent years the returns for which are due on or after July 12, 1962.

If an audit precludes the disturbing of depreciation for a subsequent year, it necessarily precludes the disturbing of depreciation for the year of the report. Such an interpretation is consistent with the statement in Section 1, part II that the purpose of the procedure is to determine whether there is a clear and convincing basis for a change. If, by virtue of Subsection 3.05, the Commissioner cannot disturb depreciation for 1962 and 1963, how can there be a clear and convincing basis for a change in 1960 or 1961? The policy of not disturbing

depreciation unless there is a clear and convincing basis for a change did not originate in Revenue Procedure 62-21, but is a continuation of the policy announced in Revenue Ruling 90, 1953-1 Cum. Bull. 43..

Application of Revenue Procedure 62-21
To Vernon and Theodora Graves

Without citation of authority, the Commissioner denies the solace of Section 62-21 to Vernon and Theodora Graves because their tax returns were never audited. Sub-section 3.05 does not speak in terms of the taxpayer whose return has been audited. Rather, Subsection 3.05 speaks in terms of the acceptance of class life used by the taxpayer. This acceptance can just as well occur upon the audit of the return of an owner of an undivided interest in the property. Applying the objective of Revenue Procedure 62-21, if there is no clear and convincing basis for changing the depreciation used by an owner of an undivided major interest, how can there be a clear and convincing basis for a change in the depreciation used by the owner of an undivided minor interest?

Commissioner Ignores His Own Declaration of Policy
Concerning Adjustments in Depreciation Deductions

Nowhere in his brief does the Commissioner mention his announced policy that agents shall propose adjustments in depreciation deductions only where there is a "clear and convincing basis for a change." This policy was first announced in Revenue Ruling 90, 1953-1 Cum. Bull. 43, and restated in Section 1, part II, Revenue Procedures 62-21, 1962-2 Cum. Bull. 418, 429.

Not only does the Commissioner disregard his announced policy, but he goes to the other extreme and claims the decision of the Tax Court supporting his depreciation disallowance should be affirmed unless clearly erroneous. In support of this proposition, the Commissioner cites three Circuit Court cases and two District Court cases. One of the Circuit Court cases cited by the Commissioner in support of his assertion, Southeastern Bldg. Corp. v. Commissioner, 148 F. 2d 879 (5th Cir. 1945), was decided in 1945, prior to the Commissioner's declaration of policy. Furthermore, the taxpayer in that case was claiming an added obsolescence deduction for a particular year in addition to the regular depreciation deductions allowed on the basis of the economic useful life assigned the building by the taxpayer. Such a situation does not fall within the Commissioner's declaration of policy even if it were in effect at that time. In contrast, the petitioners do not seek an added obsolescence deduction. They cite obsolescence factors to defend their selection of the 25 year useful life.

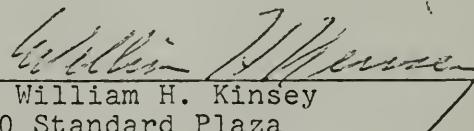
Similarly, the situation involved in Estate of Bryan v. Commissioner, 364 F. 2d 751 (4th Cir. 1966) does not fall within the Commissioner's policy declaration because the taxpayer was seeking added depreciation through a shortening of economic useful lives previously established by him. The only other Circuit Court case cited by the Commissioner, Dinkins v. Commissioner, 378 F. 2d 825, 830 (8th Cir. 1967) is not responsive to the proposition for which cited. There, the Commissioner was relying upon the taxpayer's own replacement

experience in accordance with the mandate of Massey Motors v. United States, 364 U.S. 92 (1960) and Hertz Corporation v. United States, 346 U.S. 122 (1960).

Neither of the District Court cases cited by the Commissioner (Br. 25) makes reference to the Commissioner's declared policy that depreciation deductions will be disturbed by him only where there is a clear and convincing basis for a change. Perhaps, the policy had not been called to the Court's attention. One of the cases, Warnecke v. United States, 256 F. Supp. 800 (S.D. N.Y. 1966) contained a finding that the building represented the highest and best use of the land which contrasts with the contrary testimony of petitioners' expert witness rejected as not material by the Tax Court.

Respectfully submitted,

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CERTIFICATE

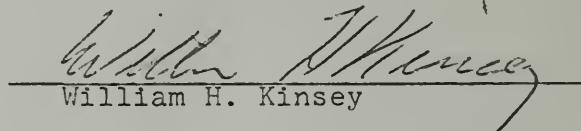
I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

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CERTIFICATION OF SERVICE

I, WILLIAM H. KINSEY, attorney for Appellants, hereby certify that I served by mail three true and correct copies of the Appellants' Reply Brief on counsel for the Commissioner of Internal Revenue on the 29th day of January, 1968. I further certify that the copies were placed in a sealed envelope addressed to Mitchell Rogovin, Assistant Attorney General, Department of Justice, Washington, D. C. 20530; said sealed envelope was then deposited in the United States Post Office at Portland, Oregon on the day last mentioned with the postage thereon fully paid.



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